



University of Rennes

University of Caen

# Local power to tax and devolution : an empirical assessment of the French constitutional reform

Alain Guengant (CREM – CNRS)  
Jean Michel Josselin (CREM – CNRS)

may 2006

Series : Public Economics and Social Choice  
WP 2006-12



Centre for Research in Economics and Management  
UMR CNRS 6211

Working paper

# **Local Power to Tax and Devolution: An Empirical Assessment of the French Constitutional Reform**

**Alain Guengant and Jean-Michel Josselin** (*corresponding author*)

University of Rennes 1 (France) and Centre National de la Recherche Scientifique (CREM UMR 6211)

**Summary:** The article explores the content and consequences of the French constitutional reform of March 2003. Among the objectives of that reform, one is to preserve the tax autonomy for the local public sector; another is to ensure that the coming wave of devolution of competencies to decentralised levels of government will be adequately financed. These constitutional safeguards are assessed and they prove to be somewhat counterproductive, as if the recourse to the higher level of juridical norms could not replace the legislative level when reforms of local public finance, however difficult, have to be conducted.

**JEL classification:** D70, H70

**Key-words:** Central government, Constitutional reform, France, Local public sector, Local taxation, National grants.

**Correspondent: Jean-Michel Josselin**

Faculté des sciences économiques

7, place Hoche CS 86514

F-35065 Rennes cedex France

Tel: 33 2 23 23 35 74 / 09

Fax: 33 2 99 38 80 84

[jean-michel.josselin@univ-rennes1.fr](mailto:jean-michel.josselin@univ-rennes1.fr)

# **Local Power to Tax and Devolution: An Empirical Assessment of the French Constitutional Reform**

## **1. Introduction**

Fiscal federalism increasingly places decentralised levels of government at the heart of its analyses (Oates, 2005). The emphasis is no longer simply on financial relations but also on the stability and self-enforcing properties of the institutional structures of government (Weingast, 1995). In particular, the constitutional setting has become a relevant and necessary dimension of public finance (Buchanan, 1990). In this context, the issue of devolution concerns both federations confronted with creeping centralisation, and unitary states in search of a more efficient assignment of prerogatives (Inman and Rubinfeld, 1997; Josselin and Marciano, 2004). The present article intends to describe and assess a case study of devolution in a unitary state.

The implementation of devolution in a unitary state is the prerogative of the central government, which does not prevent a significant level of decentralisation and competition (Rose-Ackerman, 1981; Salmon, 2000). Such is certainly the case of France and its two "Decentralisation Acts" of 1982 and 2004-2008. Concurrently, the local public sector has soon felt concerned about the preservation of its financial autonomy, hence the temptation of a constitutional safeguard.

The aim of the article is to show that this constitutional safeguard may in the future turn out to be counterproductive. In order to demonstrate it, we first provide an overview of the constitutional reform of March 2003 (section 2). We then consider the evolution of the autonomy of the local public sector for a given perimeter of competencies. The corresponding section 3 thus mainly deals with the assessment of the local power to tax in the static setting of a given allocation of prerogatives among levels of government. Section 4 uses a dynamic setting in which the perimeter of local competencies is or will be extended through the devolution process. It then assesses the impact of tax reform and tax sharing on local autonomy. Section 5 provides concluding remarks.

## **2. The constitutional reform of March 2003: an overview**

The 14 December 1789 law establishes the *communes* as the primary level of government. This basic administrative structure mirrors the 44 000 parishes of that time. The revolutionary debates are nevertheless quite significant of the ongoing discussions. According

to the 1789 law, the role of municipalities is twofold. They first have autonomous tasks to perform; they concurrently act as the agents of their common principal, the central state. This tension between the municipality-principal on its land and the municipality-agent of the centre is in principle eased with the 1958 constitution, which guarantees that the "free administration" of local communities is a constitutional statement. As we will see below, the latter turns out to be ineffective.

From the 1990s on, begins a period of constitutional reforms on various aspects of public life (there are 11 revisions between 1991 and 2003). Among them, Article 72.2 of the Constitution (Constitutional law n° 2003-276, 28<sup>th</sup> of March 2003) explicitly specifies three financial safeguards for the local public sector: tax autonomy; compensation for devolved competencies; equalisation. The first principle is meant to prevent the erosion of the local power to tax. The second one intends to provide compensations for the financing of prerogatives reassigned from the central government to the local level. In other words, the conditions of implementation of downwards subsidiarity are given a constitutional status. This is also the case with the third principle, since horizontal equity is now stated as an explicit objective.

If we leave out the objective of equalisation (Gilbert and Guengant, 2004), the other two goals of the constitutional reform are closely related to the reassignment of prerogatives towards lower levels of government. The first one consists in bending or even breaking a trend. National grants have progressively taken too much weight relatively to local taxation. Since the 1980s, reductions in local tax bases (e.g. the local business tax) or even the suppression of taxes (e.g. the taxes on vehicles for the *départements*) have been only partially compensated for by the central government. The ensuing fiscal centralisation cannot be prevented by the standard legislative game. Despite the widespread practice of concurrent political mandates, the lobbying power of the local public sector is not sufficient, hence the recourse to the constitutional level.

The second objective is to prevent excessive budgetary tensions at the local level during the decentralisation process. The reassignment of prerogatives during the "First Act" of decentralisation (1982-1983) implies an increase in expenditures that has not been fully compensated by national grants. Associated with stable or decreasing tax bases, the risk of unbalance has been reinforced by limits to tax rates increases (legal limits and, to a lesser and mitigate extent, competitive limits). In the perspective of the "Second Act" (2004-2008), the constitutional guarantee is meant to ensure balanced compensations for the transfers of prerogatives, preferably through taxation rather than by way of grants.

The following sections provide a closer look at the two objectives of tax autonomy and compensation for devolved tasks. Tax autonomy is first discussed for a given perimeter of competencies: Will the constitutional provision give an adequate safeguard against the centralisation of public finance? Second, while decentralisation endogenizes the set of prerogatives of local governments, it does not necessarily provide the right amount of resources, and the right resources to finance devolution.

### **3. Static assessment: constitutional safeguards for the local power to tax**

The constitutional guarantee of tax autonomy is interpreted by an organic law (n° 2004-758, 29<sup>th</sup> of July, 2004) which provides an explicit measure of reference for each group of local governments, namely the *communes*, *départements*, and *régions*.

#### **3.1. Providing a constitutional guarantee of tax autonomy...**

The operational principle is that the proportion of proper or distinctive resources must not be lower than a "decisive share" (*part déterminante*) of total resources. Now, the share of proper resources has been steadily decreasing in the recent past (see table 1). The trend is broken at the observed level in 2003. The references thus become 55.97% for the *communes*, 57.40% for the *départements*, and 36.07% for the *régions*. The organic law defines proper resources as those revenues directly controlled by the local assemblies. Grants and subsidies are thus non autonomous resources and the constitutional norm intends to stop their relative growth. User charges and tax revenues are obviously proper resources. If we concentrate on the latter, their local control is dependent on two variables, the tax rate and the tax base.

[Insert table 1]

At first glance, the local power to tax primarily rests on the vote of rates. In legal terms, this vote is a unilateral administrative act the effect of which is immediate and certain. Indeed, the central government bears the risk of tax collection. The main limitations come from the imposed links between rates and from the existence of upper bounds. The local power to tax is also dependent on the tax base effect. Local public policies do influence the location of individuals and firms. Services and taxes are then likely to be partially capitalised into base values. Contrary to the tax rate, the tax base effect is nonetheless uncertain and usually not immediate. The organic law does not specify that the base be sensitive to local public policies. That may in a way threaten tax autonomy whenever the impact of policies is not reflected in tax bases.

An illustration of this threat is the sharing of national taxes among different levels of government. As transfers of competencies are growing and since local tax bases (or local taxes themselves) are shrinking, the central government may be tempted to share fiscal resources whose base has no connection with local public decisions. The organic law considers this revenue as a proper one, which excessively enlarges the field of proper resources. Nevertheless, the organic law provides an imperfect but real safeguard to the erosion of tax autonomy. It is also an answer to the difficulties to reform local public finance these last twenty years.

### **3.2. ...In order to stop the decline in local taxation**

The constitutional guarantee may not have been necessary, had the reform of the local tax system been conducted properly. Conversely, the measures which have indeed been implemented have mostly contributed to a centralisation of public finance. The appeal of the local public sector to the higher norm intends to fight against both the cost of non reform and the centralising effects of implicit reform. Over the last few years, the central government has suppressed local taxes like the regional housing tax, the property tax on agricultural land for the *départements* and the *regions*. The base of the local business tax has also been reduced by removing wages from its calculus. All those expedients mostly derive from the failure to reform the system of local taxation, which proves to be more and more unequal and inefficient. The central government progressively bears an increasing part of the burden of local contributions, which are thus transferred to national taxpayers. In 2004, the central government is the first local taxpayer, financing half the local business tax, one-third of the housing tax and of the property tax on land. Only the property tax on buildings remains a local one for most of it (see figure 1).

[Insert figure 1]

What is the constitutional safeguard with regard to that situation? Before answering the question one must distinguish between two forms of tax compensations. First, legislative tax relieves (*dégrèvements législatifs*) are decided by parliament. They do not influence the tax base and hence not the local fiscal revenue. Individuals or firms are relieved of a part of their contribution, which is paid for by the national budget. For the local government, the operation is neutral and preserves its fiscal capability. Second, tax exemptions (*exonérations*) do reduce the tax base, which by the way further disconnects local public policies from tax revenues.

Compensations by the national budget for tax exemptions (*exonérations*) usually take the form of grants, or are included in an existing grant. Contrary to what happens with legislative tax relieves, this mechanism of compensation is often partial and submitted to unbalanced negotiations between the local public sector and the central government. For example, the compensating grant for the local business tax is the adjustment variable of the contractual agreement governing fiscal relations between the local and national levels. It has been substantially shrinking over the last few years. The organic law explicitly rules out grants for tax exemptions from the field of proper resources, thereby claiming the importance of tax control by local assemblies. In this respect, the constitutional guarantee is effective.

This effectiveness does not solve all the problems associated with tax compensations. Legislative tax relieves implicitly change the nature of local taxation. If we take the example of the housing tax (a similar mechanism is at work for the local business tax), the actual contribution of a household is limited by a ceiling which depends on income for contributors whose revenue is below a given threshold. The difference is accounted for by the national budget. This system *de facto* implies that the housing tax gets closer and closer to a national income tax, in particular for half of the households from urban areas (Fréville, 2003). Expensive and centralising: the evolution of the system of local taxation induces a significant cost for a national budget already tightened by excessive borrowing and deficit. It also decreases local autonomy whenever grants compensate suppressed or reduced local tax bases. The recourse to the constitutional level has been somewhat efficient by defining the proper resources of the local public sector. It has also acknowledged the failure of the legislative process in reforming public finance.

#### **4. Dynamic assessment: the ongoing devolution and the extension of the perimeter of competencies**

The First Act of decentralisation of March 1982 significantly changes the assignment of prerogatives between the national government and the local public sector. However, the following twenty years evidence an increasing discrepancy between transfers of competencies and transfers of financial means. Anticipating similar difficulties for the Second Act of decentralisation, the constitutional reform intends to prevent or at least cover the risk of excessive deficit for the local public sector.

#### **4.1. Devolution and the risk of budget deficit**

The First Act reassigns competencies to the *départements*: social assistance (but not social security), the building and maintenance of first stage secondary schools (*collèges*, for pupils aged 11-14) and school transports. The *régions* are assigned the building and maintenance of second stage secondary schools (*lycées*, for pupils aged 15-18) and professional training. For each transferred competence, the reference is the national budget expenditure for this item during the previous year. The year of the transfer, half of this amount is covered by reassigned taxes (for the *départements*: registration fees for legal transactions and a tax on vehicles; For the *régions*: another tax on vehicles). The second half consists in grants, one for current expenditures, other ones for investment. In 1986, total compensations amount to 4.1 billions € for the *départements* and 1 billion € for the *régions*.

After the first year of the transfer, the respective evolutions of expenditures and revenues no longer match. Many investments are less strategic and optional decisions than they are more pragmatically necessary conditions for maintaining the quality of public services. This is particularly the case with the renovation and modernisation of *collèges* and *lycées*. In this respect, grants follow a national indexing and they prove to be relatively inelastic, with the exception of VAT compensations. Concurrently, the devolved taxes bring a limited and fluctuating fiscal capacity. Departmental and regional assemblies then progressively shift a large part of the burden on the property, housing and local business taxes.

[Insert figure 2]

Figure 2 describes the evolution of transfers from the central government to the local public sector for the period of the First Act of decentralisation (earlier, there had been a first stage of devolution of social assistance to the *départements*). On the whole period 1979-2003, there is indeed a growing discrepancy between the transferred resources and the expenditures generated by devolution. The ambiguity of the process is that once prerogatives are devolved, the spending decisions depend both on structural outlays (for example, security requirements will cost a lot more than anticipated, particularly in the 1990s) and on strategic decisions (e.g. developing or not public school transportation). It is not easy to disentangle those two dimensions of expenditures.

During a first period (1984-1989), the situation remains relatively balanced. Increasing expenditures associated with depressed bases for the transferred taxes worsen the situation during the next period (1990-1995). The last period (1996-2003) shows a stabilisation of the situation. The suppression of one of the transferred taxes (the departmental tax on vehicles) is



compensated by a grant, which threatens tax autonomy if not budget balance. The evolution of expenditures is kept in rhythm with tax returns, but the reverse may also be true as tax returns may determine expenditures.

The announcement of a new and ambitious stage of decentralisation soon prompts the debates on compensation. About 13 billions € are to be transferred, and the local public sector would like to get assurances that the disequilibrium evidenced by figure 2 will be avoided in the future. Since the legislative game is not necessarily viewed as an efficient safeguard, local politicians (or the "local part" of national politicians) have recourse to the higher constitutional level.

#### **4.2. Constitutional safeguards and the coverage of the risk of deficit**

The Second Act broadens the perimeter of competencies by transferring prerogatives from the central to the local level, particularly at the departmental and regional levels. In 2004, the reform concerns the minimum income *RMI* (for the *départements*). From 2005 to 2008, the fields of economic development, professional training, social assistance, health, environment and culture will see many of their public policy prerogatives decentralised. First estimates evaluate the corresponding yearly expenditures to 3 billions € for the *régions*, 8.7 billions € for the *départements*. The reform also concerns civil servants of the education (96 000 administrative and technical staff) and transport and infrastructure (33 000 employees) sectors. They will be paid and administered by local governments. In this quite revolutionary context, the constitutional reform intends to prevent the risk of excessive budgetary tensions for the local public sector.

The first step is the constitutionalisation of the compensation for the devolved prerogatives. According to Article 72.2, any transfer of competencies from the state to the local public sector is associated with an allocation of resources equivalent to those previously required at the national level. That guarantee provides an instantaneous safeguard for the first year of devolution: It states that a legislative act will provide resources whenever the extension of the perimeter of competencies implies an increase in expenditures. The constitutional provision helps avoid situations in which the local public sector would be granted prerogatives... and left with the task of finding the money for financing it.

The guarantee does work for the first year(s). However, once the competence has been devolved, local governments may have to face a possible discrepancy between the expenditures involved by the new prerogatives (think of the minimum income if unemployment suddenly increases) and their budgetary capacity if the latter is ill-designed or

at least not enough responsive. In this respect, the constitutional principle of tax autonomy is meant to serve as an indirect but effective safeguard. Since proper resources must cover a "decisive share" of total resources, any preponderant financing by grants would automatically decrease the ratio of proper resources below the level required by the organic law following Article 72.2. The Constitutional Council could not but declare the compensation unconstitutional.

It follows quite logically that the main source of compensation should come from the transfer of taxes or from a proportion of shared taxes. Let us see how this principle is implemented. The compensation for devolved prerogatives is mainly financed by the allocation of tax revenues in the framework of the *Loi de finances* (the law describing the national budget on an annual basis). A complementary source of financing is provided by the *Dotation Globale de Décentralisation* (decentralisation overall grant). More specifically, the *départements* will get a non adjustable share of the *TIPP* (interior tax on oil products). They will also be granted a special tax on insurance contracts which they will have the capacity to modulate. As to the regions, they too will get a share of the *TIPP*, and we will turn to them later.

In 2004, first year of the reform, each *département* receives a share of the *TIPP* which strictly compensates devolved expenditures. The following years, the current tax revenue of the *TIPP* will serve as the basis for calculating the share of each *département*, according to a fraction initially fixed. In this setting, the tax revenue of a *département* will depend on the national yield of the tax, and consequently on the national tax base. The disconnection with local rates or bases is complete. The local governments will not have any control on the tax revenue, either through rate effects or through base effects. The departmental share of the *TIPP* thus much more amounts to a grant secured with a national tax than to a local tax or even to a shared tax since there are no local rates as such. At best, it is the revenue of the tax that is shared, but without any control (through rates or bases) by the local government. All this seems quite far from the definition of proper resources, but can be illuminated through a "public choice" explanation.

The new compensation for the transfer of the minimum income *RMI* competence has been decided after the adoption of the constitutional reform, but before the writing of the organic law. Under a strict interpretation of Article 72.2, this mode of financing would have been declared unconstitutional. It would at the same time have threatened the future of the Second Act of decentralisation. The organic law extends - stretches - the definition of proper resources by including "taxes of which law determines, for each community, the rate". In the

present case, the base is national. The allocation of the revenue among the *départments* is interpreted as the distribution of implicit local rates applied to the national base, or as the local sharing of a rate applied to that national base. Under the pressure of the government, the organic law thus weakens the constitutional guarantee of tax autonomy by providing an extensive and quite inaccurate acceptance of proper resources. For all that, it does not give a better protection against the risk of budget disequilibrium. On the expenditure side, the evolution of the level of the minimum income *RMI* and of the number of individuals who are eligible to it depends on factors that the *départements* do not really control. Parliament keeps deciding on those two variables, under the constraints of macroeconomic performances and political considerations.

As to the *régions*, they receive in 2005 a non adjustable share of the TIPP. However, from 2006 onwards, the tax base will become regional. Furthermore, after 2007 and if the EU accepts it, the *régions* will have the capacity to modulate the national rate (with lower and upper bounds). The regional TIPP will become a real "proper resource". The risk of unbalance will nevertheless remain, from both the expenditure and the revenue side.

## 5. Conclusion

In a unitary state, the reform of local public finance is normally the task of the national legislature. Since parliament has failed to achieve it, the recourse to the constitutional level can be interpreted as the search for a judicially secured stability. What was up to now mostly settled in parliament may henceforth end up before the constitutional court. Perhaps the loose formulation of "free administration" in the 1958 constitution did not provide enough safeguards. The constitutional reform of 2003 may provide too many of them.

## References

- Buchanan, James. 1990 "The Domain of Constitutional Economics", *Constitutional Political Economy* 1: 1-18.
- Fréville, Yves. 2003 "La taxe d'habitation est-elle encore un impôt local? (Is the Housing Tax Still a Local Tax?)", *Les Rapports du Sénat*, n°71, Paris, Commission des Finances.
- Gilbert, Guy and Alain Guengant. 2004 *Evaluation des effets péréquateurs des concours de l'Etat aux collectivités locales* (Assessment of the Equalisation effects of National Grants to the Local Public Sector), Paris, Commissariat Général du Plan, 2 volumes.

- Inman, Robert and Daniel Rubinfeld. 1997 "The Political Economy of Federalism", in Dennis Mueller (ed.), *Perspectives on Public Choice*, Cambridge, Cambridge University Press: 73-105.
- Josselin Jean-Michel and Alain Marciano. 2004 "Federalism and Subsidiarity, in National and International contexts", in Jurgen Backhaus and Richard Wagner (eds.), *Handbook of Public Finance*, Dordrecht, Kluwer Academic Publishers: 477-520.
- Oates, Wallace. 2005 "Toward a Second-Generation Theory of Fiscal Federalism", *International Tax and Public Finance* 12: 349-74.
- Rose-Ackerman, Susan. 1981 "Does Federalism Matter? Political Choice in a Federal Republic", *Journal of Political Economy* 89: 152-65.
- Salmon, Pierre. 2000 "Vertical Competition in a Unitary State", in Gianluigi Galeotti, Pierre Salmon and Ronald Wintrobe (eds.), *Competition and Structure: The Political Economy of Collective Decisions: Essays in Honor of Albert Breton*, Cambridge, Cambridge University Press: 239-56.
- Weingast, Barry. 1995 "The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Growth", *Journal of Law, Economics and Organization* 11: 1-31.

**Table 1: Fiscal autonomy of the local public sector****Table 1a: Municipalities and co-operation structures (*communes et groupements*)**

Billion euros or % (line g)

	1998	1999	2000	2001	2002	2003
Total revenue (a)	78.83	83.35	86.07	89.61	92.08	96.59
Borrowing (b)	7.09	8.14	8.61	8.54	8.45	9.03
Total revenue net of borrowing (c)=(a)-(b)	71.74	75.21	77.46	81.07	83.63	87.56
Tax revenue (d)	36.20	36.79	37.18	37.88	38.58	40.23
Other proper resources (e.g. user charges) (e)	7.94	8.01	8.45	8.72	8.71	8.78
Total of proper resources (f)=(d)+(e)	44.14	44.81	45.63	46.60	47.30	49.01
Ratio proper resources / total resources (g)=(f)/(c)	<b>61.53%</b>	<b>59.58%</b>	<b>58.91%</b>	<b>57.48%</b>	<b>56.56%</b>	<b>55.97%</b>

Source: our calculations from data of Direction Générale des Collectivités Locales and Direction Générale de la Comptabilité Publique

**Table 1b: Intermediate level of local government (*départements*)**

Billion euros or % (line g)

	1998	1999	2000	2001	2002	2003
Total revenue (a)	36.41	37.96	38.00	38.96	42.43	45.69
Borrowing (b)	3.11	3.06	2.92	3.51	4.29	4.63
Total revenue net of borrowing (c)=(a)-(b)	33.30	34.91	35.09	35.45	38.14	41.06
Tax revenue (d)	19.85	19.80	19.64	19.09	19.80	21.07
Other proper resources (e.g. user charges) (e)	2.53	2.62	2.60	2.50	2.48	2.50
Total of proper resources (f)=(d)+(e)	22.37	22.41	22.24	21.59	22.28	23.57
Ratio proper resources / total resources (g)=(f)/(c)	<b>67.18%</b>	<b>64.19%</b>	<b>63.38%</b>	<b>60.90%</b>	<b>58.42%</b>	<b>57.40%</b>

Source: our calculations from data of Direction Générale des Collectivités Locales and Direction Générale de la Comptabilité Publique

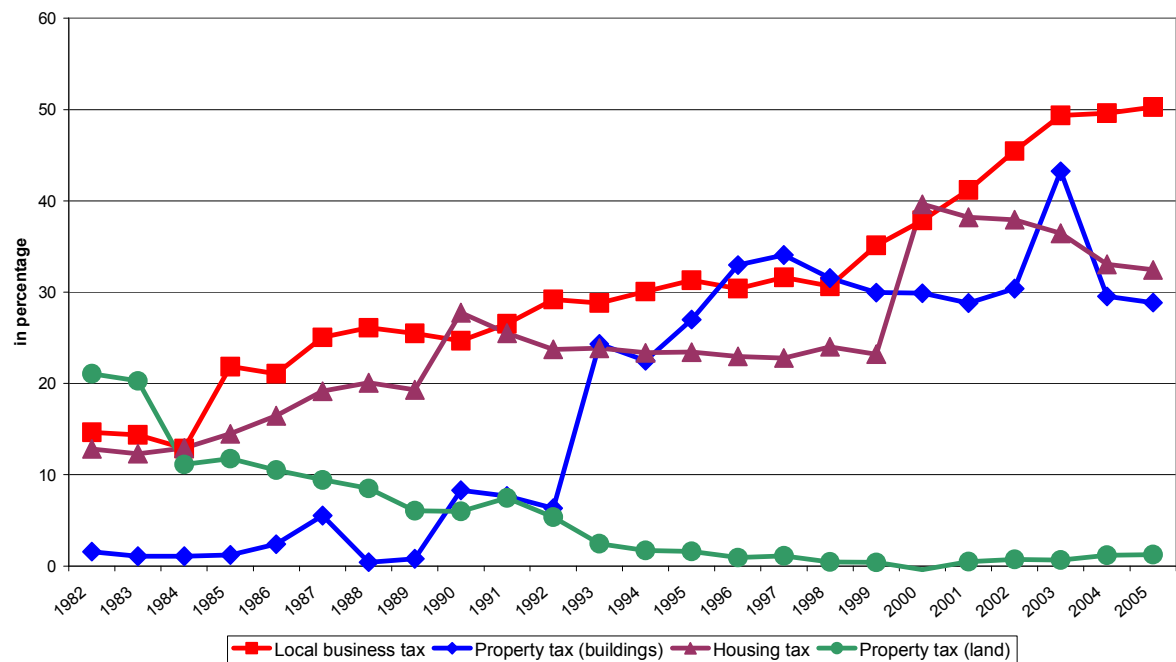
**Table 1c: Higher level of local government (*régions*)**

Billion euros or % (line g)

	1998	1999	2000	2001	2002	2003
Total revenue (a)	12.12	12.69	12.97	13.71	16.35	17.19
Borrowing (b)	1.14	1.13	1.36	1.76	2.40	2.72
Total revenue net of borrowing (c)=(a)-(b)	10.99	11.55	11.61	11.94	13.95	14.47
Tax revenue (d)	6.33	5.63	5.83	5.00	5.08	5.02
Other proper resources (e.g. user charges) (e)	0.25	0.19	0.20	0.18	0.23	0.20
Total of proper resources (f)=(d)+(e)	6.58	5.81	6.03	5.18	5.31	5.22
Ratio proper resources / total resources (g)=(f)/(c)	<b>59.87%</b>	<b>50.30%</b>	<b>51.94%</b>	<b>43.88%</b>	<b>38.06%</b>	<b>36.07%</b>

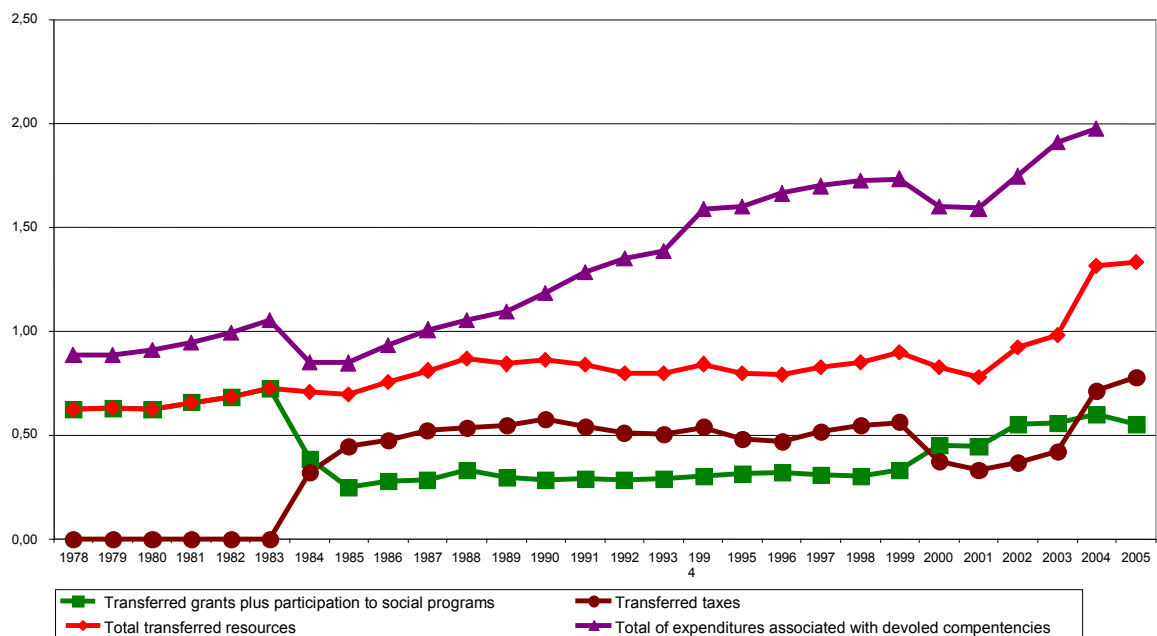
Source: our calculations from data of Direction Générale des Collectivités Locales and Direction Générale de la Comptabilité Publique

Figure 1 : Share of local taxes borne by central government (in percentage)



Source: our calculations from data of Direction Générale des Collectivités Locales and Direction Générale de la Comptabilité Publique

Figure 2: Transfers from central government to local public sector (in percentage of GDP)



Source: our calculations from data of Direction Générale des Collectivités Locales and Direction Générale de la Comptabilité Publique